The Weekly Round-up

Friday 15 December 2023

In his latest weekly round-up, Guy Foster, our Chief Strategist, analyses US inflation figures, interest rate decisions from the Federal Reserve and Bank of England, and Chinese economic data.

The glass is very much half full for the investment world at the moment, with good news being taken as such and bad news being shrugged off.

Continuing the theme of the last two months, gains have come from the anticipation of a more benign inflationary outlook. European inflation numbers have seemed to endorse that view, dropping quite sharply over the last few months. US inflation has been more nuanced; data released this week were broadly in line with expectations, but the underlying composition of inflation could give cause for concern.

US core inflation picked up during November to a pace that would be inconsistent with the Federal Reserve meeting its inflation target. It is well understood that core inflation is heavily influenced by shelter, and shelter inflation will reflect rents and changes in house prices with a lag, representing the time it takes for tenancy agreements to be renewed. That means there should be some disinflation to come from the housing slowdown that has already occurred. More recently, the impact of housing on the consumer price index (CPI) has become clouded. Demand for new housing seems depressed but house prices have been rising for the last few months. The recent sharp decline in bond yields means that US mortgage rates have been declining, which ought to offer further support for house prices and have some knock-on effect for shelter CPI.

Moreover, the Fed looks beyond core CPI these days to try and gauge underlying price pressures. While core inflation strips out volatile food and energy prices, so-called 'supercore' inflation comprises services inflation excluding energy and housing. This measure should reflect the general level of inflationary pressure driven by the balance of the labour market. It accelerated slightly this month and has been running ahead of the Fed's implied inflation target for the last four months.

Interest rates

With this backdrop, the Federal Reserve announced its latest changes to monetary policy. Broadly, policy was left unchanged, as had been universally expected, but the press conference and statement surprised the market by being more dovish than anticipated. The Fed cut its inflation expectations and raised its growth expectations for what is left of 2023. More meaningfully, it also lowered the expected interest rate at the end of 2024 to a level that implies three interest rate cuts will take place over the year. This comes at a time when the Fed is also expecting inflation to remain above target (albeit only modestly). It is surprising the Fed would endorse rate cuts whilst seeming to tolerate above target inflation. For context, market-based interest rate expectations moved lower and now imply nearly six interest rate cuts over the next twelve months.

Labour markets are the key determinant of the inflationary environment but are often observed to be lagging indicators. By the time the unemployment rate has started rising, it has often developed a momentum that makes it difficult to stop. The fear of this, at a time when Fed chairman Jerome Powell believes policy is "well into restrictive territory", will be the motivation for this dovish tilt.

One factor that has been helpful in curtailing inflation in the US is the relatively benign performance of wages. Wage growth peaked around the turn of last year in America but has not yet done so definitively in the UK or eurozone.

Europe

That discrepancy probably motivated the Bank of England (BoE) in its more hawkish tone. Three Monetary Policy Committee (MPC) members voted to raise interest rates again, believing there was evidence of persistent inflationary pressure. They were outvoted and policy was left on hold.

The MPC decision came after the release of quite weak monthly gross domestic product (GDP) data on Wednesday, on top of Tuesday's relatively poor labour market data. BoE governor Andrew Bailey took a more predictable line, emphasising the battle to contain inflation was not yet won and the Bank would "take the decisions necessary to get inflation all the way back to 2%".

All central banks become heavily motivated by the latest economic data at potential turning points in interest rate cycles. The data for the UK does seem quite weak, whereas there are tentative signs of the European economy recovering some momentum. This morning saw a slight setback in the purchasing managers indices for Germany and France. This was mirrored by the UK's ailing manufacturing sector but bucked by the UK services sector, which expanded faster for a fourth consecutive month.

Meanwhile, in the east…

A lot of data was released this week detailing the Chinese economy. There are some signs of recovery, with annual growth numbers like the 10% expansion in retail sales seeming quite healthy. This is somewhat illusory though, as China was in lockdown this time last year. The thorn in the side of the Chinese economy remains the property market. Data released today showed the continued decline in new home prices. It comes after the conclusion of the Central Economic Work Conference (CEWC). The post-meeting communique signalled some measures would come in to try to bring relief to the Chinese economy. But the promise was vague and modest, suggesting perhaps a couple of interest rate cuts and a further easing of required reserves at banks (which would enable them to lend more to the economy).

China maintained its growth target of around 5%, which sounds ambitious given the weakness of the economy. But, again, this reflects the fact that last year, China was in lockdown, and so growing 5% from that depressed level should be neither taxing nor impressive.